THE ROLE OF REALIZED AND REALIZABLE PAY IN DISCLOSURE AND BEYOND

Across most western jurisdictions (particularly the US, UK, Canada, and Australia), companies are increasingly disclosing "realized" or "realizable" executive pay levels to help tell their pay-for-performance story. Companies contend that these pay calculations provide more valid comparisons for performance than the compensation disclosure according to accounting standards, which may include amounts that executives will never receive. For most Asian companies, the issues of realized and realizable pay disclosures are probably a few years away. However, aligned with corporate governance best practices it is likely that remuneration disclosures will evolve in this direction over time. This article discusses the reasons for using realized and realizable pay, how they differ from disclosure according to accounting standards, their growing credibility, and the advantages and disadvantages of using each. It also provides examples of how they are typically disclosed.

This article is the last in a series of three perspectives on executive remuneration disclosures in Asia. The first article in the series offered six tips for companies to enhance their executive remuneration disclosures and the second article was a comparative overview of executive remuneration disclosure requirements across all Asian jurisdictions.

A SUPPLEMENTARY VIEW TO ACCOUNTING DISCLOSURE VALUES

The main source for information about a public company's executive pay is the annual report on remuneration, which typically discloses accounting values (or proxy statements in the US). But many believe that these values are flawed for performance comparisons because they include the accounting grant-date fair values for equity-based awards. Executives may never realize these values if, for example, options expire underwater or performance-based grants fail to vest.

To better tell their pay-for-performance story, a growing number of western companies in the US, UK, Canada, and Australia are supplementing the required disclosures with realized and realizable pay. More companies than ever before are likely to disclose realized and realizable pay in 2014. Since a large portion of executive pay is equity-based, using actual or current equity values is likely to show better pay-performance alignment than accounting standards' disclosures. This is particularly true in a down market when many stock options are underwater and performance goals are not being met.

NO STANDARD DEFINITIONS

There are no standard definitions for realized and realizable pay. Realized pay is generally compensation actually *received* during a stated period (typically one year), regardless of when granted — the "take home pay." Realized pay generally does not require any subjective judgments and its components are fairly consistent among companies. We discuss realized pay in greater detail in the first article of this *Perspective* series.

In contrast, realizable pay adjusts compensation to reflect the impact of company performance (stock price and other performance metrics) on potential pay values. It is typically the actual or potential value of compensation *granted* during a stated period, regardless of when received. It is often presented as cumulative pay over three or five years. Realizable pay definitions vary among companies and proxy advisors, with the most significant differences being the treatment of equity awards.

The following table presents definitions of realized and realizable pay commonly used, including alternative treatments of equity under realizable pay.

Table 1. Definitions of Realized and Realizable Pay

Compensation element	Accounting standards	Realized pay	Realizable pay
Salary	Salary for fiscal year	Same	Same
Bonus/ non-equity incentives	Bonus earned for fiscal year	Same	Same
Options/stock appreciation rights (SARs)	Grant-date fair value of awards granted during fiscal year	Actual gains realized at exercise during fiscal year	• *Options/SARs granted and exercised during the covered period:* actual gains realized at exercise, or period-end intrinsic value • *Options/SARs granted during the covered period and outstanding at end of period:* period-end intrinsic or Black-Scholes value
Stock awards (service-based vesting)	Grant-date fair value of awards granted during fiscal year	Vesting date value of awards vested during fiscal year	• *Restricted stock (RS) and restricted stock units (RSUs) granted and vested during the covered period:* vesting-date value or period-end value • *Unvested RS and RSUs granted during the covered period:* period-end value
Stock awards (performance-based vesting)	Grant-date fair value of awards granted during fiscal year	Vesting date value of awards vested during fiscal year	• *Performance periods that began and ended during the covered period:* actual value paid out* • *Performance periods that began during the covered period and are still in progress:* period-end value based on target or estimated performance
Cash long-term incentives	Amount earned for performance periods that include fiscal year	Same	• *Performance periods that began and ended during the covered period:* cash paid* • *Performance periods that began during the period and are still in progress:* cash value based on target or estimated performance
Perquisites and other benefits	Perquisites and all other compensation	Often included, as reported according to accounting standards	Sometimes included, as reported according to accounting standards

**May also include actual value paid out for performance periods that began before the covered period and were paid out during the period*

REALIZABLE PAY GAINS CREDENCE

Realizable pay is emerging as a valuable tool for evaluating pay and performance. Some investors have lauded these alternative values as useful additions to required pay disclosures. Because realized and realizable pay may result in pay values lower than the accounting standards' disclosure, particularly in a down market, investors may view them skeptically. However, many investors favor their use as an appropriate way to measure and analyze executive pay. When shareholders assess their companies' executive pay levels, they do so using the information most readily available, which includes the accounting standards-based summary compensation table and past performance. In the future, we expect more companies to include additional tables that describe pay actually realized by executives in an effort to demonstrate a better alignment. Indeed, this is one of Mercer's tips to enhance compensation disclosure as presented in the first article of this series.

WHICH PAY MEASURE IS BETTER?

There are advantages and disadvantages to both realized and realizable pay, as outlined below:

Realized Pay: Simple but Imperfect

Realized pay has the advantage of simplicity — subjective judgment is generally not needed to compute cash received, options exercised, and shares vested. But realized pay may be considered incomplete because it does not include a value for in-progress (or unvested) awards, where performance goals or vesting schedules have not yet been met.

Also, realized pay figures have limited utility for pay and performance comparisons since they are affected by individual decisions, such as when executives decide to exercise options. For example, say one executive exercised a significant number of options to finance a new house but made no other exercises for several years before or after that transaction, while another executive exercised options and sold shares regularly, which provides predetermined exercise and sale dates. The first executive will show a spike in pay for one year, while the other will show small incremental pay increases over several years.

Realizable Pay: More Complex but a Better Yardstick?

Realizable pay can be harder to define than realized pay — particularly where performance-based pay is involved — although we expect that common definitions are likely to emerge over time. In addition, although an improvement from disclosing accounting values, realizable pay includes a value for in-progress (or unvested) performance awards that may never be earned and options that may never be exercised. Despite these shortcomings, realizable pay may best meet the objective of assessing pay and performance alignment over a set time period by capturing potential value based on stock price and performance results at a common date. But one has to ensure that the time horizon over which realizable pay is measured matches the performance horizon.

BETTER FORMS FOR PAY-FOR-PERFORMANCE COMPARISON

Companies generally should disclose realized or realizable pay to show closer alignment between pay and performance or simply to demonstrate that accounting standards' values overstate executives' true compensation (see Table 2 for example).

Many US companies use realized and realizable pay to rebut proxy advisors' pay-for-performance tests and to remind investors that accounting standards' values and realized and realizable pay values serve different purposes: the former represents market-competitive opportunities that will pay out based on *future* results, while realized and realizable pay values are intended to correlate with *past* performance.

Most often, realized and realizable pay disclosures appear in executive summaries in the compensation discussion section of the remuneration report (or proxy statement in the US). Tables are useful to compare realized or realizable pay figures to accounting values and are more common for realized pay (see Table 2).

Graphs are helpful in demonstrating pay and performance relationships and are predominantly used for presenting realizable pay (see Figures 1 and 2).

Table 2. Disguised Example of Realized Pay

Name (position)	Year	Fixed remuneration and benefits	Short-term incentive cash payment	Equity award as reported	Equity award vested	Total compensation as reported	Total realized compensation	Ratio of total realized and reported compensations
Grace Weng (*Chief Executive Officer*)	2013	7,400,000	2,312,500	6,054,545	3,027,273	15,767,045	12,739,773	81%
	2012	7,350,000	2,296,875	6,013,636	1,503,409	15,660,511	11,150,284	71%
	2011	7,325,000	2,289,063	5,993,182	898,977	15,607,244	10,513,040	67%
Jiawen Diego (*Chief Financial Officer*)	2013	4,500,000	1,406,250	3,681,818	3,313,636	9,588,068	9,219,886	96%
	2012	4,000,000	1,250,000	3,272,727	3,109,091	8,522,727	8,359,091	98%
	2011	3,800,000	1,187,500	3,109,091	2,642,727	8,096,591	7,630,227	94%
Qinyao Kho (*Vice President, Marketing*)	2013	4,400,000	1,787,500	3,000,000	900,000	9,187,500	7,087,500	77%
	2012	4,300,000	1,746,875	2,931,818	586,364	8,978,693	6,633,239	74%
	2011	4,150,000	1,685,938	2,829,545	282,955	8,665,483	6,118,892	71%
Ray Ahuja (*Vice President, Operations*)	2013	3,600,000	1,462,500	2,454,545	2,209,091	7,517,045	7,271,591	97%
	2012	3,200,000	1,300,000	2,181,818	1,854,545	6,681,818	6,354,545	95%
	2011	3,100,000	1,259,375	2,113,636	1,902,273	6,473,011	6,261,648	97%
Claire McCarthy (*Vice President, Distributions*)	2013	1,950,000	792,188	1,329,545	332,386	4,071,733	3,074,574	76%
	2012	1,925,000	782,031	1,312,500	590,625	4,019,531	3,297,656	82%
	2011	1,895,000	769,844	1,292,045	193,807	3,956,889	2,858,651	72%

TABLE 2 KEY HIGHLIGHT

The last column shows that over the past three years, the realized pay is lower than pay reported as per accounting standards.

Figure 1. Disclosure of CEO's Realizable Pay vs. Total Shareholder Return Percentiles

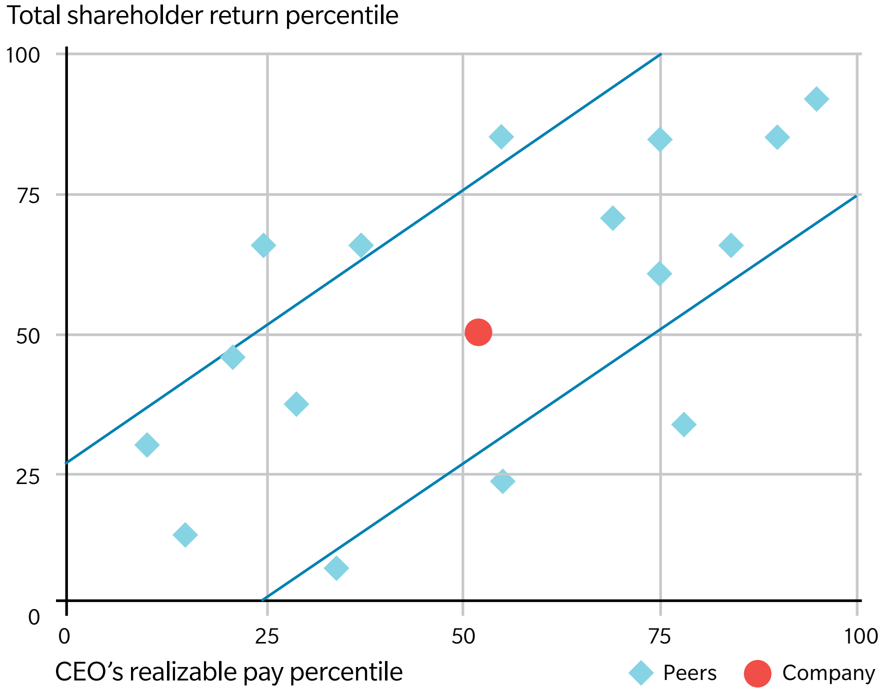

FIGURE 1 KEY HIGHLIGHT
Graph showing CEO's realizable pay is well-aligned with company's TSR performance, both relative to peers.

Figure 2. Disclosure of CEO's Realizable Pay vs. Company's Stock Performance

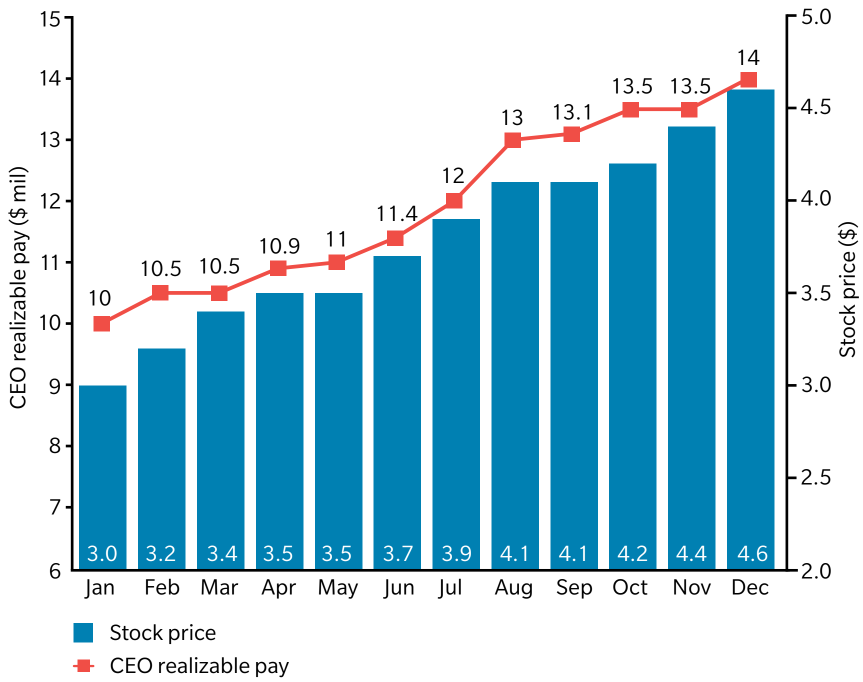

FIGURE 2 KEY HIGHLIGHT
Graph showing CEO's realizable pay is strongly linked to share price movements, thereby demonstrating the link between executives' and shareholders' interests.

BEYOND DISCLOSURE

With proxy advisors in the US, UK, Canada, and Australia acknowledging the legitimacy of realizable pay and incorporating it into some of their analyses, the concept should gain even more ground. More companies can be expected to enhance their compensation story by disclosing realized or realizable pay. Some discrepancies in definitions are likely to remain until the adoption of pay-for-performance rules within accounting standards. Companies that choose to supplement required accounting disclosures with realized or realizable pay should select the best presentation for their situation and explain why these values make more sense than accounting values and/or proxy advisor values.

The debate on the best way to analyze the pay-performance link goes beyond disclosure, however. Regardless of whether a company opts to disclose realized or realizable pay, board remuneration committees should study/review these analyses before they make compensation decisions. The alternative calculations can help directors discern if pay plans are actually paying for performance or if pay and performance are misaligned. Anomalies can signal directors that changes may be required, such as harder or easier performance goals, additional vesting criteria, or higher or lower target pay levels. Such calculations can help build shareholder trust.

Voluntary disclosures should be generally consistent from year to year to avoid creating the impression that the company is manipulating its disclosures to always present its story in a favorable light.

MERCER PERSPECTIVE

Mercer expects that in Asia, companies will also gradually enhance their compensation story by disclosing realized or realizable pay. Voluntary disclosures should be generally consistent from year to year to avoid creating the impression that the company is manipulating its disclosures to always present its story in a favorable light.

In this three-part executive remuneration perspective series, we presented our views on how Asian companies can shift their compensation disclosures and governance to global best standards. The first article presented six tips for boards of Asian companies to enhance compensation disclosures, the second article compared the disclosure requirements across Asia and contrasted these against UK standards, and the final article has provided additional perspectives on realized and realizable pay, which Asian companies may need to evolve toward over the coming years. If you would like to receive an e-copy of the first two perspectives, please contact Shai Ganu at shai.ganu@mercer.com.

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